Supreme Court, U. S.
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No. 97-885

In The

# Supreme Court of the United States

October Term, 1997

PAUL J. ENGELHART, *et al.*,

*Petitioners,*

*vs.*

CONSOLIDATED RAIL CORPORATION, *et al.*,

*Respondents.*

*On Petition for Writ of Certiorari to the United States Court of Appeals for the Third Circuit*

## RESPONDENTS' BRIEF IN OPPOSITION

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## QUESTION PRESENTED

Whether ERISA prevents an employer's amendment to a dramatically overfunded defined benefit pension plan to use a small portion of the surplus to benefit existing plan participants, consistent with this Court's decision in *Spink v. Lockheed Corporation*, 116 S. Ct. 1783 (1996).

## LIST OF PARTIES

The petitioners are Paul J. Engelhart; William J. McIlfatrick; H.C. Kohout; Carl C. Brandt; Lawrence Cirillo; Charles D. Nester; Thomas F. Meehan, Jr.; Jacqueline A. Mace; Donald E. Kraft and Robert E. Graham. The respondents are Consolidated Rail Corporation; Supplemental Pension Plan of Consolidated Rail Corporation; The Pension Administration Committee of the Supplemental Pension Plan of Consolidated Rail Corporation; Mellon Bank, N.A.; and the Trustee of the Supplemental Pension Plan of Consolidated Rail Corporation.

## RULE 29.6 STATEMENT

Consolidated Rail Corporation ("Conrail") is a wholly-owned subsidiary of Conrail, Inc. ("CRR"). CSX Corporation ("CSX") and Norfolk Southern Corporation ("NSC") have acquired all outstanding shares of CRR in connection with a proposed acquisition of CRR, which proposed acquisition is currently pending before the Surface Transportation Board ("STB"). NSC has a 58% equity interest and 50% voting interest in CRR. CSX has a 42% equity interest and a 50% voting interest in CRR. All of the common stock of CRR is held indirectly for the benefit of CSX and NSC and has been placed in a voting trust to avoid unauthorized control of CRR prior to STB approval of the proposed acquisition.

Conrail's subsidiaries, other than wholly-owned subsidiaries, are Indiana Harbor Belt Railroad Company, LMS Partnership, Albany Port Railroad Corporation, Peoria & Pekin Union Railway Co., Lakefront Dock & Railroad Terminal Company, TTX Company, and Belt Railway Company of Chicago.

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## OPINIONS BELOW

The judgment order of the court of appeals affirming the district court's grant of respondent Consolidated Rail Corporation's ("Conrail") motion to dismiss on the issues raised in the petition is unreported and is reproduced in the appendix attached to the petition, "Pet. App." at 1a-2a. The district court's opinion granting Conrail's motion to dismiss petitioners' surplus claims is not reported, and is reproduced in the petitioners' appendix, Pet. App. at 3a-17a. The order of the court of appeals denying the petitioners' request for rehearing is not reported, and is reproduced in the petitioners' appendix, Pet. App. at 18a-19a.

## STATEMENT OF THE CASE

On April 1, 1976, Consolidated Rail Corporation ("Conrail") created the Employees' Supplemental Pension Plan of Consolidated Rail Corporation (the "ESPP"), a defined benefit pension plan.[1] Petitioners are all former employees of Conrail or its predecessor companies who are participants in the ESPP.

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1. A defined benefit plan is one where the employee, upon retirement, is entitled to receive a fixed periodic payment regardless of the performance of the plan's assets. *Commissioner v. Keystone Consolidated Indus. Inc.*, 508 U.S. 152, 154 (1993).

> A defined benefit plan is distinguished from "a defined contribution" plan (also known as an "individual account" plan), under which the employer typically contributes a percentage of an employee's compensation to an account, and the employee is entitled to the account upon retirement.

*Pension Benefit Guar. Corp. v. LTV Corp.*, 496 U.S. 633, 637 n.2 (1990) (citations omitted). Should poor management of the plan

(Cont'd)

While the country as a whole experienced a recessionary period in the 1980's, the sound strategy of the ESPP's investment managers produced unprecedented growth in the assets available to satisfy the plan's obligations. The ESPP's net assets mushroomed from $494,321,407 in 1983, to over one billion dollars, $1,034,422,135, at the start of the plan year 1994.

On March 26, 1990, when the ESPP had a surplus[2] of more than $400,000,000, Conrail amended the ESPP to provide early retirement incentives for some of the plan participants through the creation of a Special Voluntary Pension ("SVP"). The alleged cost of the SVP — approximately $100,000,000 — was purportedly paid from the ESPP surplus. On November 9, 1991, when the ESPP had a surplus in excess of $390,000,000, the ESPP was further amended, pursuant to section 420 of the Internal Revenue Code, 26 U.S.C. § 420, and ERISA, to provide health care benefits for plan participants through the creation of the Health Benefits Account. The cost of the Health Benefits Account was allegedly paid from the ESPP surplus.

According to petitioners, in 1994, the plan surplus was approximately $538,162,706. Neither amendment to the plan affected the bargained-for agreement by which Conrail remained

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(Cont'd)
assets impair the plan's ability to make the scheduled payments from the plan assets, the employer must make up any deficiency from its own assets. In addition, if the investment of plan assets is successful and produces a surplus, the employer benefits. *Brillinger v. General Electric Co.*, 130 F.3d 61, 62 (2d Cir. 1997) (citing *Malia v. General Electric Co.*, 23 F.2d 828, 830 n.2 (3d Cir. 1994)).

2. Surplus is the assets above those needed to satisfy the plan's actuarially-determined obligations to participants. *Malia*, 23 F.3d at 830.

obligated to pay benefits, and petitioners' accrued benefits under the ESPP were not in any manner reduced. Simply stated, petitioners are receiving all of the benefits promised to them, and the remaining surplus provides a substantial funding cushion to insure the payment of these benefits.

## REASONS FOR DENYING THE WRIT

The lower courts correctly resolved the issues before them and, as such, there is no special or important reason for granting review of this matter. Defined benefit pension plan participants, like these petitioners, have no present interest in the assets securing their pensions, and enjoy only a contractual right to a stream of benefit payments. *Johnson v. Georgia-Pacific Corp.*, 19 F.3d 1184, 1186 (7th Cir. 1994). Because petitioners cannot show that Conrail's plan amendments impaired their right to benefits, the lower courts properly dismissed their surplus claims. In addition, the amendments to the ESPP providing for the additional benefits do not constitute fiduciary activity and, thus, are immune from scrutiny under ERISA.

This case does not present a conflict among the circuit courts or present an important federal question. Petitioners' suggest, without legal or factual support, that the Third Circuit's judgment order affirming the district court's dismissal at the pleading stage conflicts with the Ninth Circuit's decision in *Jacobson v. Hughes Aircraft Co.*, 105 F.3d 1288 (9th Cir. 1997). None of the facts critical to the Ninth Circuit's decision is present here; hence, the conflict petitioners suggest is imagined, not real.

## I.

## THE COURT BELOW FULLY CONSIDERED AND CORRECTLY DECIDED THE ISSUES.

Petitioners claim that Conrail's amendments to the ESPP, to increase participants' benefits through the creation of the SVP and the Health Benefits Account, violate ERISA's fiduciary standards. They predicate their arguments on a claim that these amendments utilized a portion of the ESPP's surplus assets, although hundreds of millions of dollars remain to satisfy their future benefits. The lower courts properly concluded that Conrail's amendments to the ESPP relate solely to Conrail's role as "settlor" of the ESPP, not as a "fiduciary", and thus fall outside ERISA's fiduciary duty standards. Moreover, defined benefit plan surplus is not a tangible *res* to which plan participants may properly make claim, and the employer's use of these monies is one of the incidental benefits of defined benefit plan sponsorship recognized by this Court.

ERISA does not require employers, such as Conrail, to establish benefits plans or to grant employees any particular level of benefits. *Spink v. Lockheed Corporation*, 116 S. Ct. 1783, 1788 (1996) (hereinafter "*Lockheed I*"). ERISA permits an employer to fulfill two roles — that of an administrator (subject to fiduciary duties) and that of a settlor or plan designer (not subject to fiduciary duties). *Varity Corp. v. Howe*, 116 S. Ct. 1065, 1071 (1996) (quoting 29 U.S.C. § 1002(21)(a)). Simply put, settlor functions do not implicate fiduciary duties or standards.

This Court's decision in *Lockheed I* disposes of the arguments advanced in the petition. Specifically, *Lockheed I* makes clear that the challenged amendments do not constitute fiduciary activity, and, as such, are not subject to ERISA. As this Court held:

> "only when fulfilling certain defined functions, including the exercise of discretionary authority or control over plan management or administration" does a person become a fiduciary under [ERISA] § 3(21)(a).

116 S. Ct. at 1789 (quoting *Siskind v. Sperry Retirement Program, Unisys*, 47 F.3d 498, 505 (2d Cir. 1995)). In *Lockheed I*, the Court found:

> "[b]ecause [the] defined functions [in the definition of fiduciary] do not include plan design, an employer may decide to amend an employee benefit plan without being subject to fiduciary review."

116 S. Ct. at 1789 (quoting *Siskind*, 47 F.3d at 505). Accordingly, plan design and amendment, such as that challenged here, do not trigger ERISA's fiduciary standards.

Indeed, Congress precisely legislated both the allocation and the circumstances and timing of the distribution of the surplus held by a defined benefit plan.[3] ERISA provides that petitioners

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3. The Seventh Circuit's decision in *Georgia-Pacific*, described the nature of the employer's promise of benefits to participants, and the severe limitations on participants' rights to the underlying trust assets:

> [T]he retirees do not own the assets of a defined-benefit pension plan. Their contributions purchased not a pool of assets (as would be the case with a defined-contribution plan) but a promise of benefits. *Employees who contribute to a defined-benefit plan are in this respect like persons who purchase annuity contracts from insurance companies.* They obtain a guaranteed stream of payments; the insurer (or, with pension plans, the employer) bears the investment risk.

*Georgia-Pacific*, 19 F.3d at 1186 (emphasis added) (citations omitted).

may be entitled to a portion of the surplus ESPP assets only upon termination of the plan and, until then, they have no legally cognizable interest in that surplus.[4] Moreover, the use of the term "surplus" is something of a misnomer:

> Consider what the "surplus" of a defined-benefit plan is. It is not a pile of assets stacked in the corner. It is instead an accounting construct. The plan determines the value of its assets — stocks, bonds, real property, cash, and so on. It also estimates the cost of fulfilling all of the promises to pay vested benefits. The former computation yields the asset side of the balance sheet, the latter computation the liability side. The difference between these is the "surplus" or "deficit" . . . .

*Georgia-Pacific*, 19 F.3d at 1189.

Further, petitioners' conclusory allegation that Conrail received some benefit by amending the ESPP does not alter the conclusion that Conrail's decision to amend the ESPP falls outside the boundaries of ERISA's fiduciary standards. In *Lockheed I*, the Court explained that the receipt of a benefit by the employer redesigning or amending a pension plan is permissible under ERISA:

> [A]mong the "incidental" and thus legitimate benefits that a plan sponsor may receive from the operation of a pension plan are attracting and retaining employees, paying deferred compensation, settling or avoiding strikes, providing increased compensation without increasing wages, increasing employee turnover, and reducing the likelihood of

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4. *See Malia*, 23 F.3d at 832 ; *Georgia-Pacific*, 19 F.3d at 1189.

> lawsuits by encouraging employees who would otherwise have been laid off to depart voluntarily. . . .

*Lockheed I*, 116 S. Ct. at 1791 (citing Brief of Respondent Spink at 11). Any incidental gain arguably received by Conrail as a result of the creation of the SVP and the Health Benefits Account falls squarely within these enumerated, permissible benefits. For example, Conrail's decision to enhance the benefits of those participants who chose early retirement through the SVP merely "increas[ed] employee turnover" and "encourag[ed] employees who would have been laid off to depart voluntarily."

In addition, Conrail's 1991 decision to amend the ESPP to fund its Health Benefits Account was explicitly authorized by the 1990 amendments to the Internal Revenue Code and ERISA, specifically allowing plan sponsors to fund retiree medical plans from pension plan surplus. Indeed, Conrail relied upon section 420 of the Internal Revenue Code, "Transfers of Excess Pension Assets to Retiree Health Accounts," 26 U.S.C. § 420, to create the Health Benefits Account.

ERISA section 404(a) similarly excludes such transfers from scrutiny:

> Subject to sections 403(c) and (d), 4042 and 4044 of this title, a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries. . . .

29 U.S.C. § 1104(a). Section 403(c)(1) provides, in turn, that the assets of a plan shall never inure to the benefit of any employer *"except as provided . . . under section 420 of the*

*Internal Revenue Code of 1986 (as in effect on January 1, 1991.*"[5] 29 U.S.C. § 1103(c)(1) (emphasis added).

ERISA's "exclusive benefit rule," section 404(a)(1), 29 U.S.C. § 1104(a)(1), is equally inapplicable to petitioners' claims. As one court observed, "under a clear reading of the statute, section 420 transfers are exempt from the prudent man standard of 29 U.S.C. § 1104." *Chemtech Indus. v. Goldman Financial Group, Inc.*, 809 F. Supp. 729, 733 (E.D. Mo. 1992). ERISA section 404 expressly incorporates section 403, including its Internal Revenue Code section 420 exemption. Further, Conrail established the Health Benefits Account to assist the same employees who participated in the ESPP; thus, the benefit of the surplus flowed to the "participants," as required under ERISA section 404.

Despite petitioners' protestations to the contrary, the amendments made by Conrail, providing participants additional benefits, do not raise issues involving fiduciary conduct and, as such, may not be challenged under ERISA. Petitioners' claimed, but unsubstantiated and unwarranted, fear of some unspecified future harm does not alter this reality. Accordingly, the lower courts properly considered and rejected petitioners' claims.

## II.

## THE ALLEGEDLY CONFLICTING DECISION BY THE NINTH CIRCUIT IS READILY DISTINGUISHABLE.

The petition seeks to obfuscate the record below in an ill-fated attempt to create the illusion of similarity between *Jacobson* and this dispute. Because the facts before the Ninth Circuit were

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5. In addition, under ERISA section 408(b), transfers permitted by section 420 of Title 26 are exempt from ERISA's "prohibited transaction" provisions of section 406. 29 U.S.C. §§ 1106, 1108(b)(13) (1992).

significantly different from those here, any suggestion that a conflict exists between the Ninth Circuit and the Third Circuit based on its summary affirmance of the district court's dismissal of petitioners' claims, is erroneous.

In *Jacobson*, the Ninth Circuit reversed the dismissal of a complaint alleging that Hughes Aircraft Company ("Hughes") violated its fiduciary duties under ERISA section 404(a), 29 U.S.C. § 1104, and the anti-inurement provisions of ERISA section 403(c)(1), 29 U.S.C. § 1103, when Hughes amended its contributory defined benefit plan to freeze enrollment in the contributory portion of the plan and then established a non-contributory benefit formula for new employees. 105 F.3d at 1290-91. The complaint further alleged that the amendment at issue caused the termination of the plan and, in turn, the establishment of a new plan. In addition, the complaint asserted that use of the surplus assets allegedly attributable to employee contributions to fund benefits under the non-contributory plan improperly benefited Hughes, and reduced the plaintiffs' accrued benefits. *Id.*

Certain facts were critical to the Ninth Circuit's determination that the defendant was acting as a fiduciary at the time it amended the pension plan and was, therefore, subject to ERISA's fiduciary standards. The Ninth Circuit relied on the following: (1) Hughes purportedly terminated the pension plan; (2) the new plan was created for the benefit of employees who had not participated in the original plan; and (3) plaintiffs' accrued benefits were diminished as a result of Hughes' use of surplus assets.[6] *Id.* at 1295-96. None of these facts is present here.

First and foremost, plaintiffs claimed that the plan was

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6. The Ninth Circuit in *Jacobson* sought to distinguish its decision from this Court's opinion in *Lockheed I* on two additional grounds: (1) this Court did not address whether Lockheed violated ERISA's anti-inurement provision; and (2) the fund at issue in *Lockheed I* was non-contributory. *Jacobson*, 105 F.3d at 1293.

terminated when Hughes froze new enrollment and established a new plan. *Jacobson*, 105 F.3d at 1293. Such a termination, plaintiffs maintained, triggered their rights under ERISA section 4044, 29 U.S.C. § 1344.[7] Here, however, petitioners admit that there has been no termination of the ESPP, triggering ERISA section 4044. In their brief to the district court, dated April 28, 1993, petitioners conceded that no such termination occurred:

> At present, the plaintiffs are not suggesting that the ESPP, or any portion thereof, be terminated.
>
> * * *
>
> It simply is beyond question that the members of the Engelhart class would have rights in the plan surplus *if the ESPP were to terminate*.

Given the Ninth Circuit's significant reliance on the plaintiffs' allegation of plan termination and the absence of such an averment here, a conflict between the Ninth Circuit and the Third Circuit is absent.

A second critical distinction between petitioners' claims and those before the Ninth Circuit in *Jacobson* is the fact that, after terminating the original plan, surplus assets of that plan were used by Hughes to establish a new plan covering individuals who had not been participants in the original plan. Through the challenged amendment to the ESPP to provide for the enhanced early retirement program and the Health Benefits Account, Conrail extended additional benefits only to existing ESPP participants, and not to anyone who was not already a

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7. As noted above, ERISA section 4044, 29 U.S.C. § 1344, describes the allocation of assets upon termination of a defined benefit pension.

plan participant. *See* ESPP at 3-4. Thus, Conrail simply redesigned the ESPP to fund additional benefits to certain participants (without reducing the level of benefits of the remaining participants).

The Ninth Circuit's later opinion in *Spink v. Lockheed Corporation*, 125 F.3d 1257, 1260-61 (9th Cir. 1997) (hereinafter "*Lockheed II*"), demonstrates that the fundamental premise of *Jacobson* rested on the fact that the plan sponsor's largess was showered upon individuals who were *not* participants in the original, pre-amendment plan. Following this Court's remand of *Lockheed I*, the district court granted the defendant's motion to dismiss and the plaintiff appealed. On appeal, the Ninth Circuit specifically addressed ERISA section 403(c)(1), 29 U.S.C. § 1103(c)(1), and relying, in part, upon this Court's decision in *Lockheed I*, concluded that an employer's use of plan assets to purchase waivers for its own liability was permissible under ERISA's anti-inurement provision. 125 F.3d at 1260. More specifically, in *Lockheed II*, the Ninth Circuit relied upon and noted favorably the decisions of other circuits:

> that have held that an employer does not receive "inurement" under § 403 where plan assets were paid *only to plan participants and the plan only advances the employer's business interests.*

125 F.3d at 1261 (emphasis added) (citing cases). Accordingly, based upon the reasoning of the Ninth Circuit in *Lockheed II*, it would appear that the Ninth Circuit would reach the same conclusion that the Third Circuit reached here.

Moreover, the employee contributions to the ESPP are, at best, *de minimis*, particularly when compared to the amount of

surplus in the ESPP.[8] The plan at issue in *Jacobson*, on the other hand, was funded *equally* by employer and employee contributions. 105 F.3d at 1291. Further, and quite unlike the facts in *Jacobson*, these petitioners always enjoyed the right to withdraw their contributions before retirement. Central to the Ninth Circuit's ruling in *Jacobson* was the plaintiffs' specific allegation that when Hughes used the surplus, it reduced their accrued benefits. *See* 105 F.3d at 1293. Here, however, petitioners never alleged, because they could not, that the creation of the SVP and the retiree Health Benefit Account reduced or otherwise affected petitioners' accrued benefits. Simply stated, notwithstanding the amendments to the ESPP, petitioners continue to receive *all* of the benefits owing under the terms of the plan.

In light of the clear emphasis placed by the Ninth Circuit on the fact that Hughes had terminated its pension plan, that outsiders to the plan were benefited by Hughes' use of plan surplus, and that the plaintiffs in *Jacobson* claimed that their actual benefits had been reduced as a result of the creation of the new plan, the unique and readily distinguishable factual

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8. As recited in the complaint, employee contributions comprised an insignificant portion of the ESPP's assets:

| PLAN YEAR | EMPLOYEE CONTRIBUTIONS |
|---|---|
| 1982 | $ 15,949.00 |
| 1983 | $ 136,196.00 |
| 1984 | $ 83,403.00 |
| 1985 | $ 195,725.00 |
| 1986 | $ 86,092.00 |
| 1987 | $ 284,994.00 |
| 1988 | $ 73,411.00 |
| 1989 | $ 65,753.00 |
| 1990 | $ 38,328.00 |

basis for that decision does not support petitioners' claim here of a conflict among the circuits. The ESPP was merely amended, not terminated, to provide supplemental benefits to certain of the plan's participants. In light of these matters and the uncontroverted and continued robust financial condition of the ESPP, it is evident that no harm has befallen petitioners requiring this Court's intervention or review.

## CONCLUSION

Petitioners' claims were properly rejected as falling outside ERISA and the decisional conflict they describe is illusory, when considered in light of the framework of that statute, case law and factual setting. The petition should be denied.

Respectfully submitted,

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